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THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001 AND ITS EFFECT ON ESTATE PLANNING

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"We have long had death and taxes as the two standards of inevitability. But there are those who believe that death is the preferable of the two. 'At least,' as one man said, 'there's one advantage about death; it doesn't get worse every time Congress meets.'"

- Erwin N. Griswold

"We have from time-to-time complained about the complexity of our revenue laws and the almost impossible challenge they present to taxpayers or their representatives.... Our complaints have obviously fallen upon deaf ears."

- Arnold Raum (Senior U.S. Tax Court Judge)

INTRODUCTION

While, as Erwin Griswold states, death is preferable to taxes because it does not get worse every time Congress meets, *planning* for death is a different story. As though the Internal Revenue Code (I.R.C.) was not complicated enough, Congress enacted the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).[1] At first blush, EGTRRA looks advantageous; who would not be happy to have estate taxes "repealed"? As is often the case with changes to the tax code, there is a catch. The estate tax repeal is phased in over a nine-year period, with complete repeal happening for one year only, in 2010. Thereafter, the tax rates and provisions go back to the

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1. *See* Pub. L. No. 107-116, 115 Stat. 38 (2001).

way they were before EGTRRA was introduced, provided Congress takes no action in the meantime.

It is the uncertainty of EGTRRA's future changes that provides a great number of challenges to estate planning. Will permanent repeal actually occur? Alternatively, will estate and generation skipping transfer (GST) taxes be preserved, but at substantially increased exclusion and exemption amounts and at a substantially lower maximum tax rate?[2] This uncertainty makes it very difficult for estate planning attorneys to properly address or even understand EGTRRA's changes and difficult to explain to their clients.[3] This article examines the estate, gift, and GST tax provisions of EGTRRA and the challenges these provisions pose to estate planning.

EXPLANATION OF EGTRRA

What exactly is EGTRRA? While to some, the word "EGTRRA" may sound like "the name of a radioactive chicken that destroys Tokyo,"[4] EGTRRA actually provides one of the most extensive changes to the federal estate tax code that we have seen yet, with EGTRRA's ultimate goal being complete repeal of the estate tax.[5]

ESTATE, GIFT, AND GST TAX: RATE REDUCTIONS AND EXEMPTION INCREASES

EGTRRA put in place many provisions that, over a period of several years, significantly alter the estate, gift, and GST tax rates and exemption amounts. EGTRRA phases-down the maximum estate, gift, and GST rate of tax at intervals, starting at fifty percent in 2002 and reducing the rates down to forty-five percent in 2009.[6] In 2010, the estate and GST tax rates are set at zero, while the gift tax rate will remain at the maximum marginal income tax rate of thirty-five percent.[7] Additionally, EGTRRA increases the estate tax applicable exclusion amount

2. HOWARD M. ZARITSKY, WAITING OUT EGTRRA'S SUNSET PERIOD: PRACTICAL PLANNING WHILE CONGRESS DEBATES ESTATE TAX REPEAL 1 (2004).

3. *See id.*

4. Dave Barry, *Want a Little Something EGTRRA?* MIAMI HERALD, Apr. 6, 2003, at 1M.

5. Mark B. Edwards, THROUGH THE LOOKING GLASS: THE FUTURE OF ESTATE AND FINANCIAL PLANNING (WITH FORM), Vol. 19, No.1 PRACTXL 7, 8 (Fall 2004).

6. I.R.C. § 2001(2)(B).

7. I.R.C. §§ 2210(a), 2664.

(the estate tax exemption equivalent of the unified credit), the gift tax exemption, and the GST exemption. The estate tax applicable exclusion and the GST exemption are increased in intervals up to $3.5 million in 2009, while the gift tax exemption remains fixed at $1 million.[8] In 2010, the estate tax applicable exclusion and the GST exemption are unlimited, while the gift tax exemption remains fixed at $1 million.[9] In effect, EGTRRA partially severs the integration of the federal estate and gift tax that began in 1976. Finally, EGTRRA tied the amount of GST exemption to the estate tax applicable exclusion for estates of decedents dying after December 31, 2003 as well as for generation-skipping transfers made after December 31, 2003 and effectively eliminated the annual adjustments that had indexed the GST exemption for inflation[10]

The exemption equivalents and tax rates, as currently in effect under EGTRRA, are as follows:

Year	*Tax Rate*	*Exemption/Exclusion*
2005	47%	$1.5 million for estate and GST taxes; $1 million for gift tax
2006	46%	$2 million for estate and GST taxes; $1 million for gift tax
2007	45%	$2 million for estate and GST taxes; $1 million for gift tax
2008	45%	$2 million for estate and GST taxes; $1 million for gift tax
2009	45%	$3.5 million for estate and GST taxes; $1 million for gift tax
2010	0% (Gift tax set at top income tax rate of 35%)	Unlimited for estate and GST taxes; $1 million for gift tax

It is hard not to focus on, and for that matter look forward to, the *unlimited* estate tax applicable exclusion. However, sunset provisions are attached to EGTRRA. This means that,

8. I.R.C. §§ 2010(c), 2505(a)(2).
9. I.R.C. §§ 2210(a), 2664.
10. I.R.C. § 2631(c).

after midnight on December 31, 2010, all of the above mentioned changes to the tax rate and exemption and exclusion amounts will revert to the pre-EGTRRA amounts.[11] Between now and December 31, 2010, Congress has the option to extend EGTRRA's terms at a specific level of exemption and tax rate or to make the repeal permanent. However, if Congress does not take any action in that time, all of the changes under EGTRRA will be eliminated, or "sunset." The federal estate, gift, and GST tax rate will return with a maximum marginal rate of fifty-five percent (with an additional five percent surcharge for certain large estates), the estate tax applicable exclusion amount and the GST tax exemption will no longer be tied together, and the applicable exclusion amount will be returned to the $1 million it was scheduled to reach in 2006 under the law in place before EGTRRA was adopted.[12]

This sunset provision causes a lot of estate planning challenges because of the sheer uncertainty of what future estate tax might exist when a client passes away, if it exists at all. With three more congresses and one more president to be elected before 2010, a lot could change regarding the estate tax. In fact, Congress has already proposed legislation that would extend the estate tax changes at much higher exemption amounts and reduce tax rates or repeal the estate tax early, but so far these proposals have failed because the Senate has not agreed to their passage. In June of 2002, for example, the House of Representatives passed the Permanent Death Tax Repeal Act, but it did not pass in the Senate.[13] The House tried again in June of 2003 with the passage of the Death Tax Repeal Permanency Act, but, again, this bill failed in the Senate.[14] President George W. Bush strongly supported the House of Representatives' action to make the tax relief permanent and stated that the vote was a "victory for fairness . . . and certainty. . . ."[15] The President

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11. I.R.C. § 2210.

12. *See id. See also* ZARITSKY *supra* note 2, at 1-9.

13. *See* S. Amendment 3833, Death Tax Elimination Act of 2001, S5412, S5434 (June 12, 2002), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getpage.cgi?position=all&page=S5400&dbname=2002_record (last visited Apr. 13, 2005).

14. *See* H.R. 8, Death Tax Repeal Permanency Act (June 18, 2003), *available at* http://www.whitehouse.gov/omb/legislative/sap/108-1/hr8sap-h.pdf (last visited Apr. 13, 2005).

15. Statement by President George W. Bush, President Pleased with House Action on Death Tax, (June 18, 2003), *available at* http://www.whitehouse.gov/news/releases/2003/06/20030618-12.html (last visited Apr. 13, 2005).

further urged the Senate to take similar action so that this tax could be eliminated once and for all.[16] President Bush continues to support the full repeal of the estate tax, a change that could be seen during the President's next four years in office. In February of 2004, President Bush announced his fiscal year 2005 budget, which, among other things, focused on continuing to strengthen the economy by making permanent the tax relief he signed into law, including the phase out of the estate tax.[17] Additionally, in this past election, Republicans won enough seats in both the House and the Senate that Republicans are now the dominating party in each; therefore, there is a greater likelihood of success for the President's proposals. Thus, changes to EGTRRA could appear in the near future, making it necessary for estate planners to remain abreast of congressional action.

This uncertainty must be taken into account along with the uncertainty of when a client will pass away. Even a younger client, who would be expected to live for many years, could be in an unfortunate situation where he or she unexpectedly passes away much sooner than expected. Estate plans that are drafted must be flexible and take into account the changing estate tax environment. For married couples, this may mean that the formula approach used with the AB trust[18] will be an even more important planning tool. This approach allows the plan to be drafted in such a way that clients maximize their federal estate tax exemption. Depending on the size of the estate, the formula approach under the AB trust can effectively eliminate federal estate taxes. Similarly, the qualified terminable interest property (QTIP) trust[19] will also be a very important planning tool because of the flexibility it provides. The QTIP trust allows a client to elect the amount of assets to receive the marital deduction at the time of filing the estate tax return for the decedent-spouse.[20] This is a valuable feature in such a changing environment.

There are additional changes under EGTRRA that affect estate planning. Two that will be addressed in this article are

16. *Id.*

17. Fact Sheet, President Bush's FY 2005 Budget, 2004 WL 188164 (White House) (Feb. 2, 2004).

18. *See infra* notes 57 through 64 and accompanying text for an explanation of the AB trust.

19. *See infra* notes 65 through 69 and accompanying text for an explanation of the QTIP trust.

20. I.R.C. § 2056(b)(7)(v).

the phase out of the state estate tax credit, which has a very large impact on techniques used for estate planning, and the change to the carry over basis rules.

PHASE OUT OF THE STATE ESTATE TAX CREDIT

A significant change as a result of EGTRRA is the phase out of the state estate tax credit. Before EGTRRA, federal law allowed a dollar-for-dollar credit against federal estate tax liability for any amount of state estate and inheritance tax paid up to a certain amount.[21] The maximum amount of the credit depended on the size of the estate.[22] All states had an estate tax equal to at least the amount of the credit, also known as a pickup tax, thus tying every state's estate tax to the federal credit.[23] For example, if client X died in 1998 and paid $100,000 in state estate tax, the amount of client X's federal estate tax due would be credited, or reduced, by the $100,000 paid to the state. Under EGTRRA, this credit was phased out in four steps.[24] Specifically, EGTRRA reduced the state estate tax credit by 25% in 2002, 50% in 2003, 75% in 2004, and has fully repealed it this year, 2005.[25] If client X were to die in 2004 and still owed the $100,000 to the state, that client's federal estate tax bill would have only been credited with $25,000. This year the client's credit will be zero. The state death credit has been replaced with an unlimited state tax deduction with respect to decedents dying after December 31, 2004,[26] which has its own set of regulations regarding when the deduction will be allowed.

The phase out of the credit is essentially eliminating state estate taxes in most states, resulting in substantial revenue losses to states. Because of this, states have started taking action to adjust for the loss in revenue by changing their estate tax laws. At least seventeen states and the District of Columbia have done

21. I.R.C. § 2011(a)(1), (b)(1).

22. *Id.*

23. Some states impose an inheritance tax in addition to a state estate tax tied to the federal credit. *See, e.g.*, CONN. GEN. STAT. ANN. §§ 12-340, 12-314b, 12-344 (West 2004); IND. CODE ANN. § 6-4.1-2-1 (West 2005); IOWA CODE ANN. §§ 450.1-450.3 (West 2004); KY. REV. STAT. ANN. § 140.010 (Banks-Baldwin 2004); LA. REV. STAT. ANN. § 47:2401 (West 2004); OKLA. STAT. ANN. tit. 68, § 802 (West 2004); TENN. CODE ANN. §§ 67-8-303, 67-8-304 (2004).

24. I.R.C. § 2011(b)(2).

25. *Id.*

26. *See* I.R.C. § 2011(f).

what is called "decoupling," or separating, from the changes in the federal tax code by remaining linked to the federal law as it existed prior to the change. This severs the ties between the states' estate tax and the current federal estate tax law.[27] It is estimated that the remaining states that have not decoupled "stand to lose $6 billion through fiscal year 2005 and $14 billion through fiscal year 2007"[28] as a result of this change under EGTRRA. Because of this substantial loss in revenue, it is a wonder why some states have not yet decoupled. In many states already decoupled, deciding to decouple was accomplished through action by the legislature. However, in a few states there are additional barriers to decoupling. California, for example, requires taxpayer approval before decoupling,[29] while Alabama, Florida, and Nevada would need to alter their respective constitutional provisions in order to change their state estate tax laws.[30]

For those states that are decoupled, it is important to note that they are not all decoupled in the same way. Some states have decoupled only from the phase out of the credit,[31] while other states have decoupled from both the credit and the exemption.[32] Some states are decoupled indefinitely, unless they take future legislative action to reconform to the federal changes,[33] while other states are decoupled only for a certain number of years.[34]

This phase out and subsequent decoupling cause significant

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27. Elizabeth C. McNichol, *Many States are Decoupling from the Federal Estate Tax Cut*, revised Jan. 14, 2004, Center on Budget and Policy Priorities, *at* http://www.centeronbudget.org/5-23-02sfp.htm (last visited Apr. 13 2005).

28. Iris J. Lav & Andrew Brecher, *Passing Down the Deficit*, revised Aug. 8, 2004, Center on Budget and Policy Priorities, *at* http://www.cbpp.org/5-12-04sfp.htm (last visited Apr. 13 2005).

29. McNichol, *supra note* 27; *see also* CAL. CONST. art. 13C §§ 1-2.

30. McNichol, *supra note* 27; *See also* ALA. CONST. amend. 23; FLA. CONST. art. 7, § 5; NEV. CONST. art. 10, § 4.

31. *See, e.g.*, VT. STAT. ANN. tit. 32 §§ 7402, 7442(a) (2004).

32. *See, e.g.*, D.C. CODE ANN. § 47-3701 (2004); 35 ILL. COMP. STAT. 405/2, 405/3 (2004); ME. REV. STAT. ANN. tit. 36, § 4062 (West 2004); MD. CODE ANN., [TAX-GEN.] § 7-309 (2004); R.I. GEN. LAWS § 44-22-1.1 (2003); WASH. REV. CODE ANN. § 83.100.020 (West 2004); WIS. STAT §§ 72.01(11m), (11n), & 72.02 (2004).

33. *See, e.g.*, D.C. CODE ANN. § 47-3701 (2004); ME. REV. STAT. ANN. tit. 36, § 4062 (West 2004); MD. CODE ANN., [TAX-GEN.] § 7-309 (2004); R.I. GEN. LAWS § 44-22-1.1 (2003); VT. STAT. ANN. tit. 32 §§ 7402, 7442(a) (2004); WASH. REV. CODE ANN. § 83.100.020 (West 2004).

34. *See, e.g.*, 35 ILL. COMP. STAT. 405/2, 405/3 (2004); N.C. GEN. STAT. § 105-32.2 (2004); WIS. STAT §§ 72.01(11m), (11n), & 72.02 (2005).

challenges to estate planning. If Congress takes no action to make the repeal permanent or lock in the estate and GST tax rates and exemption amounts at a certain level, then the credit will return in 2011 and those states that did not decouple will again have a state estate tax. However, since the phase out happens rather quickly compared to the rest of EGTRRA's provisions and many states have already taken action to compensate for this change, it seems likely that the phase out will remain and states that have decoupled will stay that way. Even if Congress does decide to reinstate the credit, it would be very complicated for decoupled states to go through the process of recoupling.

This uncertainty requires special consideration when planning for clients who own real property in more than one state. For these clients it will be important to find out where they own real property and then to find out how that state is handling the phase out under EGTRRA so that a plan can be put into place to minimize state estate taxes in more than one state. Planning choices may be muddled because of the inconsistent state estate tax rules.

WISCONSIN'S APPROACH TO THE PHASE OUT

Wisconsin, like many states, only levied the pick up tax as its form of estate tax.[35] In reaction to EGTRRA, Wisconsin decoupled from the federal changes through action by the state legislature.[36] Wisconsin has tied its estate tax to the maximum federal credit available under federal tax laws in effect on December 31, 2000, but only for deaths occurring from September 30, 2002 through December 31, 2007.[37] For deaths occurring after December 31, 2007, Wisconsin's law is written such that the estate tax will equal the credit in effect at the time of the decedent's death; in other words, it will be zero.[38] Wisconsin has also frozen its estate tax exemption at $675,000 for deaths occurring before January 1, 2008.[39]

It is uncertain why Wisconsin decided to recouple with federal law in 2008 and beyond. While the revenue generated in

35. WIS. STAT. ANN. § 72.02 (West 2005).
36. WIS. CONST. art. 8 § 8.
37. WIS. STAT. ANN. § 72.01(11m) (West 2005).
38. *Id.*
39. WIS. STAT. ANN. § 72.01(11n) (West 2005).

Wisconsin from estate tax is not one of the top sources of tax revenue,[40] it is significant enough that full repeal of the state estate tax seems unlikely. Although, if Congress takes no action between now and December 31, 2010, the changes under EGTRRA will sunset; thus, Wisconsin's estate tax will come back in 2011. Wisconsin would only be without the revenue from the estate tax for three years, and perhaps the legislature felt it would not affect the total revenue too much to be without this particular source of revenue for those three years. Alternatively, if Congress does take action to preserve the estate and GST exemption amounts at higher levels and the tax rates at lower levels or to fully repeal it, then the changes under EGTRRA will not sunset. Without action from the state legislature, Wisconsin's estate tax would not be reinstated.

It does not, however, seem likely that Wisconsin will forego this additional revenue at all, much less indefinitely. Because Wisconsin conformed to the phase out provisions under EGTRRA for deaths occurring between January 1 and September 30, 2002, Wisconsin's estate tax collections for fiscal year 2002 were $82.6 million and were estimated to be $74 million in 2003, about $35 million less than they would have been had Wisconsin not conformed.[41] Now that Wisconsin is decoupled and following prior federal law, it is estimated that it will take in $118.6 million for fiscal year 2004 and $126.3 million for fiscal year 2005.[42] It is hard to imagine that Wisconsin would not change its law sometime before December 31, 2007 so as to not lose this source of revenue.

The fact that Wisconsin decoupled from the federal estate tax creates challenges for the estate planner. For married couples, techniques such as the AB trust[43] that have been used to avoid paying federal estate tax, may need to be tailored to the fact that Wisconsin's maximum exemption amount is only $675,000 and no longer in sync with the federal estate tax

40. WIS. DEP'T OF REVENUE DIVISION OF RESEARCH AND POLICY, STATE AND LOCAL TAXES IN WISCONSIN, Dec. 2, 2002, *at* http://www.dor.state.wi.us/ra/02alltax.pdf (last visited Apr. 14, 2005).

41. WIS. DEP'T OF REVENUE DIVISION OF RESEARCH AND POLICY, WISCONSIN ESTATE TAX, Dec. 23, 2002, *at* http://www.dor.state.wi.us/ra/estate02.pdf (last visited Apr. 14, 2005).

42. *Id.*

43. *See* discussion *infra* notes 57 through 64 and accompanying text for an explanation of the AB trust.

exemption amount until 2008.[44]. Additionally, the QTIP trust[45] will be important for providing flexibility. The use of a QTIP trust would allow a surviving spouse to elect the amount of assets to count towards the marital share at the time of the first spouse's death.[46] This will be very beneficial since it is not known what Wisconsin will do with its estate tax beyond December 31, 2007. Planning for single individuals is even more complicated, because the techniques discussed above are not available to the single person. These clients will want to take advantage of lifetime and annual exclusion gifting to reduce the size of their gross estates.[47] Additionally, these clients may want to use an irrevocable life insurance trust (ILIT)[48] to ensure that there will be liquid assets available upon their deaths to pay any estate taxes that may be owed.

THE CARRY OVER BASIS

While the carry over basis change under EGTRRA does not seem to pose as much of a concern to estate planners, it is still a change that could affect clients and, therefore, should be understood. Under the current law, a person who receives property from a decedent takes, as his or her adjusted basis, the fair market value (FMV) of the property on the date of the decedent's death.[49] For example, if a client passes away and leaves stock to his or her son with a basis of $10,000 and a FMV on the date of the client's death of $50,000, the son will take an adjusted basis of $50,000 in the stock. If the stock decreases in value and the FMV of the stock on the date of the client's death was $7,000, the son would take an adjusted basis of $7,000. EGTRRA changes the treatment of the carry over basis, but only for the year 2010. A person who receives property from a decedent who dies between January 1 and December 31, 2010 will take an adjusted basis equal to the lesser of the adjusted basis of the decedent or the fair market value of the property on

44. WIS. STAT. ANN. § 72.01(11n) (West 2005).

45. *See* discussion *infra* notes 65 through 69 and accompanying text for an explanation of the QTIP trust.

46. I.R.C. § 2056(b)(7)(B)(v).

47. *See* I.R.C. §§ 2010, 2503 (the annual exclusion amount is currently $11,000 per person and is adjust for inflation in amounts of $1,000).

48. *See* discussion *infra* notes 73 through 76 and accompanying text for an explanation of the ILIT.

49. I.R.C. § 1014(a)(1).

the date of the decedent's death.[50] EGTRRA essentially preserves the step-down in basis under present law, while eliminating the step-up in basis for property that appreciated in value.[51] Going back to the above example, if the client died in 2010 and the stock appreciated in value to $50,000 on the date of the client's death, the son would now take $10,000 as his adjusted basis. However, where the stock fell in value to $7,000, the son would still take the $7,000 as his adjusted basis.

Certain property will be entitled to additional basis adjustments for the year 2010, which takes two forms: a $1.3 million aggregate basis increase and a $3 million spousal property basis increase.[52] These basis increase amounts can be used to increase the basis of property up to, but not in excess of, the property's FMV.[53] Thus, in the preceding example where the client died in 2010, if the FMV were $50,000 on the date of the client's death, the son would still take a $10,000 adjusted basis, but the executor could then allocate up to $40,000 of the aggregate basis increase to the stock, so the son would ultimately have an adjusted basis of $50,000 in the stock.

Again, it is important to understand this provision of EGTRRA, but with the change occurring for only one year, which is several years away yet, the common practice seems to be to follow the carryover basis rules currently in effect. Without a crystal ball, it is impossible to predict when clients will pass away, which makes planning for this basis change very difficult. One of the only ways to really plan around this is through lifetime gifting,[54] though it may not make sense to gift away so much that a client will incur gift tax, especially because once the gift is made and the tax is paid it cannot be changed. In contrast, a client's estate plan can be changed up until the client passes away and, if he or she was to pass away in 2010, the client would not incur any estate tax, which may make more sense than incurring gift tax earlier on.

50. I.R.C. § 1022(a).

51. *See* ZARITSKY, *supra* note 2, at 1-14.

52. I.R.C. §§ 1022(b)(B), (c)(B).

53. I.R.C. § 1022(d)(2).

54. *See* I.R.C. § 1015 ("The basis of the property will be the same as it would be in the hands of the donor . . . except that if such basis . . . is greater than the fair market value of the property at the time of the gift, then for the purpose of determining a loss the basis shall be such fair market value.").

AN EXAMPLE

One can more fully understand the changes to EGTRRA and the challenges they pose to estate planning by using an example. The difficulties in planning will first be examined using a master hypothetical and then variations to the hypothetical will be examined to see other areas of planning that can be a cause of concern under EGTRRA. In the master hypothetical, the clients are a couple named Jake and Peggy who are in need of estate planning services. Jake and Peggy are residents of Wisconsin, though they also have a home in Florida. Jake and Peggy have assets totaling $5 million. While Jake and Peggy were married on June 28, 1977, they did opt in to marital property under their prior estate plan, so all of their assets can be assumed to be owned half by each spouse.[55] Jake and Peggy are both currently fifty-four-years-old.

Some of the challenges that arise under the master hypothetical include the crystal ball problem: we do not know for certain when Jake and Peggy will pass away. While Jake and Peggy will both most likely live until 2010 or later, something unfortunate could happen resulting in either one of them passing away before 2010. Estate planning for Jake and Peggy, therefore, needs to incorporate a flexible plan that can take into account the long- and short-term perspective. When planning with a long- and short-term perspective in mind, it will be necessary for the estate planner to take into account the fact that Wisconsin has decoupled from federal estate tax and has an exemption amount set at $675,000 through December 31, 2007.[56] Additionally, because Jake and Peggy own real property with a situs in Florida, it will be necessary to understand how Florida is handling the phase out of the state estate tax credit and to verify Florida's current estate tax laws. Finally, depending on the techniques used for planning and the surrounding circumstances, ensuring that the surviving spouse will have enough money to maintain his or her standard of living may be another concern.

55. This assumption is made because Wisconsin is a marital property state.
56. WIS. STAT. ANN. § 72.01(11n) (West 2005).

THE AB TRUST

One of the main goals of estate planning is to maximize the estate tax exemption.[57] With the uncertainties and changes under EGTRRA, the most efficient way to do this may be through use of what is called an AB trust, which utilizes a formula approach to allow clients to take full advantage of their respective federal estate tax exemptions.[58] Under the formula approach, the amount of the decedent's assets that exceed the decedent's federal estate tax exemption amount go into an "A," or marital trust, such as a QTIP trust.[59] The amount in the "A" trust, while not included in the taxable estate of the decedent because it is covered by the marital deduction, *is* included in the taxable estate of the surviving spouse.[60] The "B" trust, typically a family or credit shelter trust, is structured to hold the decedent's assets up to the amount of the maximum amount of the decedent's federal estate tax exemption.[61] Usually this trust is designed such that the nonmarital share is left "for the lifetime benefit of the surviving spouse or for the joint benefit of the surviving spouse and other family members."[62] To provide some flexibility in the plan, the AB trust should be drafted in such a way that the amount dedicated to the nonmarital share automatically adjusts to the amount of the federal estate exemption, unless other circumstances dictate that this type of a set up does not meeting the client's needs. The amount in the "B" trust, because it is covered by the exemption amount, is protected from estate tax when the first spouse dies *and* passes free of estate taxes at the death of the surviving spouse.[63] Therefore, making full use of the estate tax exemption and only using the marital share for any excess assets will reduce the amount of assets subject to estate tax when the surviving spouse dies.

Under the master hypothetical, Jake and Peggy each own $2.5 million in assets. If they used the AB trust with the formula approach discussed above, their estate plan would be designed

57. *See* ZARITSKY, *supra* note 2, at 3-6.

58. *See id.*

59. *See id.*, at 3-6, 3-16.

60. *A-B Trust*, Capital Trust, *at* http://www.ctcdelaware.com/documents/downloadable/ABTRUS~1.PDF (last visited Apr. 13, 2005).

61. *Id.*

62. ZARITSKY, *supra* note 2.

63. *See A-B Trust*, *supra* note 60.

as follows:

Year	*Nonmarital Share*	*Marital Share*
2005	$1.5 million	$1 million
2006	$2 million	$500,000
2007	$2 million	$500,000
2008	$2 million	$500,000
2009	$2.5 million	0
2010	Unlimited	0
2011	$1 million	$1.5 million

Jake and Peggy maximize their current federal estate tax exemptions while simultaneously reducing the estate tax liability the surviving spouse will incur when he or she passes away. At the first spouse's death, no federal estate tax will be due, because the nonmarital "B" share will be fully covered by the federal estate tax exemption and the marital "A" share will be covered by the unlimited marital deduction.

However, using the traditional formula approach also has a disadvantage for Jake and Peggy, because they will end up owing Wisconsin estate tax (depending on the year of death). The following chart illustrates the amount of assets that would be subject to Wisconsin estate tax:

Year	*Nonmarital Share*	*WI Exemption*	*Amt. Subject to WI Estate Tax*	*Amt. of WI Estate Tax*[64]
2005	$1.5 million	$675,000	$825,000	$26,880
2006	$2 million	$675,000	$1,325,000	$57,040
2007	$2 million	$675,000	$1,325,000	$57,040
2008	$2 million	No WI Estate Tax	0	0
2009	$2.5 million	No WI Estate Tax	0	0
2010	Unlimited	No WI Estate Tax	0	0
2011	$1 million	$1 million	$500,000	$12,400

This is one example where structuring the nonmarital trust to automatically increase to equal the federal estate tax exemption amount may not be the best approach. To avoid incurring Wisconsin estate tax, it may be necessary to alter the terms of the formula by setting the nonmarital share amount at $675,000, with the remaining amount of assets going to the marital share. While this will eliminate federal estate tax as well as state estate tax, neither Jake nor Peggy will be maximizing their respective applicable exclusion amount, which creates a real disadvantage upon the second spouse's death. The decoupling of some states, such as Wisconsin, from the federal estate tax because of the phase out of the credit under EGTRRA, ultimately creates the need for a planning technique that is disadvantageous to surviving spouses.

THE QTIP TRUST

The QTIP trust is an important tool in estate planning and is even more important in the uncertain environment under EGTRRA because of the flexibility it provides. Qualified terminable interest property is property that passes from the

64. These amounts are approximate and are determined using the table in I.R.C. § 2011(b) (as in effect pre-EGTRRA) and using the amount in the "Amount Subject to Wisconsin Estate Tax" column as the amount for the adjusted taxable estate.

decedent, in which the surviving spouse has a qualifying income interest for life.[65] The surviving spouse must be the sole beneficiary of the property, must receive all the income from the property, and no one can have the power to appoint any part of the property to anyone other than the surviving spouse.[66] While the trust is set up for the sole benefit of the surviving spouse, each spouse also designates the contingent beneficiary(s) to receive the proceeds from the QTIP trust after the death of the surviving spouse.[67] Using our hypothetical, if Jake and Peggy had two children, Dick and John, they could each establish a QTIP trust set up for the sole benefit of the other spouse, with Dick and John named as the contingent beneficiaries. Thus, if Jake were to pass away first, Peggy would receive income for her lifetime from the QTIP trust, and upon her death, the remainder of the trust would pass to Dick and John. Peggy does not have the power to change the contingent beneficiary designation.

Using a QTIP trust adds flexibility to a client's estate plan because the QTIP trust does not automatically qualify for the marital deduction. Instead, all or a portion of the trust can qualify for the marital deduction upon election by the executor of the estate on the federal estate tax return.[68] Typically the QTIP trust is used in conjunction with the AB trust; thus, any assets not receiving the marital deduction would go to the nonmarital, or "B," trust. An estate tax return must be filed nine months after the death of an individual, unless an extension is filed, which provides an additional six months to file the estate tax return.[69] This provides a lot of flexibility by giving the executor of the estate up to fifteen months after a spouse passes away to decide how much, if any, of the assets should pass to the marital share. If the Wisconsin estate tax is eliminated at the time of death and Jake passes away in 2009, the executor can elect to leave the maximum amount of the federal estate tax exemption to the nonmarital share, with the remainder receiving the marital deduction. If, however, Jake passes away in 2005, the executor can elect to leave only $675,000 to the nonmarital share, with the remainder receiving the marital deduction.

65. I.R.C. § 2056(b)(7).
66. *Id.*
67. *Id.*
68. I.R.C. § 2056(b)(7)(v).
69. I.R.C. §§ 6075(a), 6081(a).

With this flexibility, however, does come one drawback – a lack of control. Once assets are put into the QTIP trust, a trustee is in charge of making distributions from the trust. The surviving spouse has very little, if any, control over the assets. While the QTIP trust works well in theory, especially in the changing estate tax climate under EGTRRA, ultimately the QTIP trust is not used as often as might be imagined. It is simply too difficult to get clients to relinquish control. In certain situations, such as second marriages, the QTIP trust is used more often, where a lack of control is what the clients desire.

FLORIDA ESTATE TAX

An additional concern for Jake and Peggy is their second residence with a situs in Florida. The phase out of the state estate tax credit under EGTRRA and the resulting decoupling by many states has made planning in this type of circumstance much more challenging. Ultimately, estate-planning attorneys need to be aware of how all of the situs states of their clients' real property are handling the phase out. Florida, in fact, is one of the states that has not decoupled.[70] Once the phase out is complete, Florida will no longer have an estate tax. As long as Jake and Peggy pass away between January 1, 2005 and December 31, 2010 there will be no need to worry about dealing with estate tax in Florida.[71] However, if Congress takes no action between now and then, in 2011 Florida will again have an estate tax, as the phase out of the credit under EGTRRA will sunset.[72] If Congress does act to fully repeal the estate tax or to enact it but at substantially higher exemption amounts and much lower rates, the credit will be completely eliminated, as will Florida's estate tax. Florida, under this type of a situation, may amend its constitution so that it can decouple from the federal estate tax. If this were to happen, planning techniques similar to those used when planning around Wisconsin's estate tax, such as the use of the AB trust with a fixed amount equal to the maximum Wisconsin estate tax exemption going to the nonmarital share, would also be important.

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70. *See* FLA. STAT. ANN. § 198.02 (West 2004).

71. *See* I.R.C. § 2011(b)(2) (the credit is completely phased out starting in 2005 and will remain that way through December 2010, without any action by Congress during that period).

72. I.R.C. § 2210.

The challenges to estate planning under EGTRRA do not end here. Different circumstances can make the planning process more complicated. To fully understand these additional challenges, three variations on the above master hypothetical will be examined, including: the older client in failing health, the affluent client (with assets of around $30 million), and the client who has children from a prior marriage for whom he or she wants to provide.

VARIATION 1: THE OLDER CLIENT IN FAILING HEALTH

To change the facts of the master hypothetical, it is now assumed that Jake and Peggy are both eighty-four years old and Peggy is in failing health; all other facts remain the same. The likelihood of either spouse passing away before 2010 is much greater under these circumstances, especially for Peggy who could even pass away before 2007, when Wisconsin still has an estate tax. Short-term planning, including planning to avoid both Wisconsin and federal estate taxes, becomes an even greater concern. The use of the AB trust remains important; however, it may not be as effective to use just the formula approach. Given the likelihood of one spouse, particularly Peggy, passing away before Wisconsin's estate tax is zero, it may be a better idea to set the nonmarital share at $675,000 and have the remaining assets covered by the marital share.

The above approach removes some of the flexibility of the AB trust because the nonmarital share will remain the same, even if one or both clients pass away when Wisconsin's estate tax is zero. Frequent review of the clients' estate plan can alleviate this inefficiency, though this option is certainly not optimal under the circumstances. Not only will the clients have to pay the attorney's fee each time they meet, getting to the attorney's office may become more difficult as the clients age and health issues become more problematic. Though this problem could be eliminated if the attorney makes house calls, the two-year window on meeting could simply be too long, and one of the spouses could pass away between meetings, resulting in the plan not being structured to optimally deal with the estate tax in effect at the time of death.

Another, perhaps even better option is to use a QTIP trust in conjunction with the AB trust. Though the fact that the surviving spouse would have to relinquish control over the assets does need to be factored in, the QTIP trust would provide additional and much needed flexibility to the clients' estate plan. Because of the uncertainty surrounding when Jake and Peggy will pass away, coupled with the present uncertainty of the estate tax, both federal and state, the benefits of using a QTIP trust might outweigh the cost of loss of control and would at least provide some level of certainty to a very uncertain and changing area of the law.

VARIATION 2: THE AFFLUENT CLIENT

Clients who have a substantial amount of assets have additional concerns that need to be taken into account when planning because these clients invariably will owe estate tax. The planning focus now is not only on maximizing the exemption and exclusion amounts, but also on taking advantage of techniques that will get assets out of the clients' gross estate, including lifetime and annual gifting, and on ensuring that the clients will have a source of liquid assets that can be used to pay any estate tax that may be due, because clients in this asset group typically do not have a lot of liquid assets. For this variation, it is assumed that Jake and Peggy have $30 million in assets; all of the other facts from the master hypothetical remain the same. Jake and Peggy will end up paying some amount of estate taxes, unless, of course, they can both plan to pass away in 2010—a near impossibility. The techniques discussed in the master hypothetical remain important for Jake and Peggy. Additional techniques, such as the use of life insurance, also become important, particularly the Irrevocable Life Insurance Trust.

THE IRREVOCABLE LIFE INSURANCE TRUST

For clients with substantial amounts of assets, life insurance can provide a source of liquid assets to cover estate, gift, and GST taxes that will be due upon a client's death. A life insurance policy owned outright by the decedent, however, will be included in the decedent's estate at death, and thus counted as part of his or her taxable estate and subject to federal estate taxes.[73] For example, if Jake was the insured and owner of a

73. I.R.C. § 2042.

policy with a $1 million death benefit and Jake passes away, the $1 million policy will be pulled back in and counted towards Jake's taxable estate. Peggy would still receive the proceeds, which she can use to pay the estate taxes due, but the amount of estate taxes owed will be higher because of this additional amount included in Jake's estate. For the affluent client, the best way to keep life insurance policies out of the taxable estate and avoid these problems is to have the policies owned by an Irrevocable Life Insurance Trust (ILIT).

Though complex, an ILIT provides several benefits. An ILIT can provide liquid assets to pay estate taxes by loaning money to the estate to pay off these liabilities and remove the assets it holds from the decedent's gross estate, because, when the decedent-insured passes away, the policy proceeds are paid to the ILIT not to the decedent-insured.[74] Without the liquidity provided by a properly drafted ILIT, affluent clients could be forced to sell illiquid assets, a challenging and often impractical task. The ILIT, because it is a trust, permits the management and control of policy proceeds by allowing the grantors to set the terms of the trust.

There are a few things to keep in mind when using an ILIT. First, it is an *irrevocable* trust, meaning that once created it cannot be amended or terminated. Additionally, if existing life insurance policies are transferred to the ILIT, they must be held in the ILIT for three years before they will be excluded from the policyholder's taxable estate.[75] If the policyholder passes away within three years of the transfer, the policy will be pulled back into the decedent's estate.[76] If, in this variation, Jake and Peggy were older and possibly in failing health, as in variation 1, it may not make sense to transfer existing policies to an ILIT for this very reason. The ILIT can purchase new policies, in which case the three-year restriction would not apply. Of course this only works if the person applying for the policy is insurable. Here, because Jake and Peggy are older and Peggy is in failing health, it is unlikely that either of them will still be insurable. Unfortunately, the fact that Jake or Peggy could pass away before the three-year restriction on transfers is up, coupled with their lack of insurability, makes the ILIT a rather poor planning

74. Sebastian V. Grassi, Jr., *Key Issues to Consider When Drafting Life Insurance Trusts*, 31 EST. PLAN. 390, 390-391 (Aug. 2004).

75. *Id.* at 392, I.R.C. § 2035.

76. *Id.*

technique for them. However, for younger, affluent clients and those in better health, such as under the facts of the master hypothetical, where Jake and Peggy are both fifty-four years old, the ILIT would be a very beneficial tool for them to use.

TAX DRIVEN HEALTH CARE POWER

A "tax-driven" health care power is another technique that could be used in situations where clients have substantial assets and might be in failing health. A health care power, or power of attorney for health care, is a legal document that allows individuals to name someone (called an Agent) who will make health care decisions for him or her when he or she is unable to do so any longer, specifically once that individual becomes incapacitated.[77] The health care power becomes "tax driven" when it includes a provision providing that, in the event the client is on life support, he or she should be kept alive until the most advantageous date in the tax code. For example, if Peggy was in failing health and on life support in 2009, she could include a provision in her health care power that she wanted to be kept alive until 2010, at which point she could be taken off life support and ultimately pass away without owing any estate tax.

RELOCATION

Another decision some affluent clients may make involves taking advantage of the phase-out of the state estate tax credit under EGTRRA. Specifically, affluent clients may decide to relocate to states such as Arizona or Hawaii that have not decoupled from the federal estate tax,[78] because, these states no longer have an estate tax. This could be risky considering that states that have not decoupled will again have state estate tax in 2011, providing that Congress takes no action between now and then. However, as mentioned previously, it is possible that the estate tax will be completely repealed, resulting in nondecoupled states having no state estate tax indefinitely. Using variation two of the hypothetical, Jake and Peggy may

77. Ways to Plan Ahead for Medical Care and Treatment, FindLaw (2004), *at* http://public.findlaw.com/healthcare/life_events/le23_3ways.html (last visited Apr. 13 2005).

78. *See, e.g.*, ALA. CODE § 40-15-2 (2004); ARIZ. REV. STAT. ANN. § 42-4051 (West 2004); FLA. STAT. ANN. § 198.02 (West 2004); HAW. REV. STAT. ANN. § 236D-2 (Michie 2003); S.C. CODE ANN. §§ 12-6-40(A), 12-16-20 (Law. Co-op. 2004).

decide to permanently reside in their home in Florida, since Florida has not decoupled.[79] If either Jake or Peggy were to pass away before 2011, they would avoid paying Florida estate tax. If Congress acts between now and December 31, 2010 to make the repeal permanent, Jake and Peggy could avoid paying Florida estate tax indefinitely, because the Florida state estate tax credit would be completely eliminated.[80]

VARIATION 3: CHILDREN FROM A PRIOR MARRIAGE

Providing for children from a prior marriage can be very complicated under EGTRRA, especially when using an AB trust. For this variation it is now assumed that Jake has two children, Dick and John, from a prior marriage, for whom he wants to provide. While Peggy gets along with the children, they are not extremely close. Typically, as was discussed previously, the goal behind the AB trust is to maximize each person's federal estate tax exemption amount by using the formula approach. Depending on the size of a client's total assets, this approach can eliminate all estate taxes as the "A" share is covered by the unlimited marital deduction while the "B" share is covered by the federal exemption. Also, under this approach, the surviving spouse is often a lifetime beneficiary, if not the only lifetime beneficiary, of the nonmarital share;[81] thus, if additional funds are needed, he or she can typically receive money from that share without much complication.

The use of the AB trust when planning for clients with children from a prior marriage is more difficult under EGTRRA. In these situations, the surviving spouse is often not a lifetime beneficiary of the nonmarital trust at all. Spouses who want to provide for children from a prior marriage simply do not list the surviving spouse as a beneficiary of the nonmarital trust because they want to ensure that the amount set aside for the children does in fact go to them after the spouse-parent passes away. While the amount of the estate tax exemption increases, however, the amount of assets going to the "B" trust also increases, resulting in a smaller amount going to the "A" trust. Thus, the amount left for the surviving spouse to live on is

79. *See* FLA. STAT. ANN. § 198.02 (West 2004).

80. This would be true unless Florida amended its constitution down the road to enable it to levy a different amount of state estate tax.

81. *Id.*

decreasing every couple of years, until 2010 when the amount left to the surviving spouse in the marital trust will be zero.[82] And, if Congress acts to completely repeal the estate tax, the amount going to the marital share under the formula approach will be zero indefinitely. Thus, one of the biggest concerns in this situation is ensuring that the surviving spouse will have enough money to live on and to maintain his or her standard of living.

A typical solution to this is to limit the amount going to the "B" trust, as is done in situations where a state has decoupled and the clients want to avoid state estate tax as well as federal estate tax. Limiting the amount going to the nonmarital share will ensure that some assets pass to the marital share, thus providing for both the children from the prior marriage *and* the surviving spouse. Of course, this will also be of greater or lesser concern depending on the amount of assets the clients have. Using this variation on the master hypothetical, where Jake and Peggy each have $2.5 million and use the formula approach in 2009 and 2010, the amount going to the marital share would be zero and, with other third-parties as the lifetime beneficiaries of the nonmarital trustee, Peggy would not have any additional assets to live on.[83] If Congress were to enact a permanent repeal of the estate tax, Peggy's marital share would be zero indefinitely. Here, setting a maximum amount that can go to the nonmarital share, for example, setting it at $1.5 million, will ensure that Peggy as well as Jake's children are provided for upon his death. The downfall to this approach, of course, is that Jake would not be maximizing his federal estate tax exemption. However, under these circumstances, it may be more beneficial to ensure that both Peggy and Jake's children are provided for rather than to maximize Jake's exemption.

If this variation is used, along with variation two where Jake and Peggy had $30 million in total assets, limiting the amount going to the nonmarital share may not be as important because no matter how high the exemption is increased to, there will still be a substantial amount of assets over the exemption amount going to the marital share. Even in 2009 when the exemption is

82. This assumes that the clients have more than $3.5 million each in assets so that some amount will pass to the marital share until the estate tax exemption is unlimited. If, however, each spouse has assets of $3.5 million or less, the amount going to the marital share will be zero before 2010.

83. *See supra* p. 315 for the chart showing the amount of assets going to the marital and nonmarital shares.

at $3.5 million, if Jake passed away with assets of $15 million, $11.5 million would go to the marital share ($15 million - $3.5 million). Of course, in 2010, as well as if Congress acts to permanently repeal the estate tax, limiting the amount going to the nonmarital share will become very important as in either of these situations the amount going to the marital share becomes zero. The uncertainty of not knowing what action Congress will take regarding the estate tax and when it may take this action makes it difficult to know whether to limit the amount of a client's exemption when planning, especially when children from a prior marriage are involved.

CONCLUSION

The phase out of the estate tax, followed by full repeal of the estate tax, followed by reinstatement of the estate tax at pre-EGTRRA levels, makes it very difficult for estate planning attorneys to know which techniques to use to best address their clients' circumstances. Estate planners could be relieved of this uncertainty if Congress takes some action, but what will Congress decide to do? Permanently repeal or keep it, but at substantially higher exemption amounts and lower tax rates? All of this uncertainty makes it necessary for estate planning attorneys to constantly stay up-to-date on congressional action and to stay educated on any changes that occur. It is also necessary for estate planning attorneys to educate their clients so that they understand the reasoning behind how their estate plan is drafted, to keep the estate plans as flexible as possible so that they can be adjusted to the changing estate tax environment, and to meet with their clients often to ensure that their plans are still taking full advantage of the estate tax and to ensure that if their circumstances have not changed, necessary changes are made to their plan. Regardless of what kind of action Congress taxes in the future, something needs to be done to remedy these uncertainties. As stated in a Statement of Administration Policy regarding the Permanent Death Tax Repeal Act, "[t]he time to fix this problem is now, so American families . . . can make their plans for the future today, without needlessly worrying how these plans could be jeopardized by inaction in the future."[84]

84. *See* H.R. 8, Death Tax Repeal Permanency Act (June 18, 2003), *available at* http://www.whitehouse.gov/omb/legislative/sap/108-1/hr8sap-h.pdf (last visited Apr. 13, 2005).